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Summary of the Economic and Social Survey of Asia and the Pacific 2011

Summary

The economies of Asia and the Pacific recovered strongly in 2010 from the depths of the "great recession" of 2008/09, but they face fresh challenges in 2011. These include the return of food and fuel crises that are threatening hard-won development gains, sluggish recovery in the advanced economies and a deluge of short-term capital flows that in turn is leading to volatility in capital markets, the build-up of asset bubbles and the appreciation of exchange rates. Furthermore, the devastation wrought by the recent earthquake and tsunami in Japan provides another stark reminder of the region's vulnerability to natural disasters. These challenges pose significant downside risks to an otherwise robust growth outlook as the region emerges as a growth pole of the global economy.

In addition to addressing short-term risks, policymakers have to meet the challenge of rebalancing the region's economies in favour of domestic and regional investment and consumption. While wide development gaps provide significant headroom for expanding domestic demand, deepening regional economic cooperation is also critical to sustain dynamism in coming years. Some of the areas needing policy attention are enhancement of connectivity between markets and peoples through improved transport linkages, regional institution-building, streamlined transport and trade facilitation and progress towards a regional energy framework.

The region's least developed countries have not been able to enjoy the emerging opportunities offered by expanding markets and strengthened connectivity owing to their lack of productive capacity. Besides putting in place a supportive national policy framework, they need to be assisted in building productive capacities by their development partners.

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The *Economic and Social Survey of Asia and the Pacific 2011* assesses the critical issues, policy challenges and risks that the region faces in coming months and outlines the elements of a policy agenda for sustaining dynamism and inclusive development for an Asia-Pacific century.

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I. Introduction

1. The Asia-Pacific region has recovered strongly from the 2008/09 recession but it is not out of the woods yet. The global environment in 2011 is turning out to be more difficult than that of 2010 since it will require dealing with a multiplicity of concurrent challenges. As demand from the developed world continues to remain sluggish, the region is being assailed by a resurgence in food and energy prices, with the repercussions of a host of natural disasters in the region having further impacts on both economic growth and prices. Nevertheless, the divergence in overall growth prospects for the region in the coming years as compared with the developed world suggests a central role for the Asian and Pacific region not only in driving its own development but also in being a critical anchor for the global recovery from the recession.

2. The recovery of the region has come under pressure in recent months due to dramatic increases in global food and energy prices as well as to the resumption of robust growth. This has disproportionately hurt the region's poorest and most vulnerable people and most directly impacted their livelihoods. The developing economies will also be affected by high energy prices that will increase input costs for industry, which in this region tends to be energy intensive.

3. Another key short-term challenge for the region, stemming from the recovery measures of developed countries to stimulate their economies, is the impact of the enormous liquidity injections undertaken by those countries to revive their economies. Favourable growth prospects and comparatively high interest rates in developing economies have attracted large foreign portfolio inflows from international investors to asset markets in the region. These capital inflows have led to inflationary pressures and the formation of asset market bubbles, besides exchange rate appreciation in some countries.

4. These short-term threats have been exacerbated by a host of natural disasters. The catastrophic earthquakes and tsunami that struck Japan from March 2011 have affected not only the country itself but also the wider region, owing to Japan's key role in the interconnected Asia-Pacific economy. Other major disasters have included floods in Pakistan and an earthquake in New Zealand. Food-producing economies such as Australia, China, India and Kazakhstan have in addition been affected both by drought and excess rainfall, reducing food supplies and helping push up prices. Indeed, the Asia-Pacific region as a whole seems to have suffered more from such disasters than other global regions.[1] Countries will therefore need to integrate the risk of such disasters into regional economic and social policymaking and to take measures to mitigate the effects.

5. The major medium-term challenge for the region continues to be the slow pace of recovery of the developed world and its unlikely role in being as significant a growth driver for the region as it was before the crisis. The continuing export dependence on developed country markets of many small economies in the region will mean that growth rates in the region will be impacted. Conversely, an

[1] Economic and Social Commission for Asia and the Pacific and the United Nations International Strategy for Disaster Reduction, *Asia Pacific Disaster Report 2010: Protecting Development Gains: Reducing Disaster Vulnerability and Building Resilience in Asia and the Pacific* (Bangkok, 2010). Available from www.unescap.org/idd/pubs/Asia-Pacific-Disaster-Report-2010.pdf.

increasing trend of intraregional trade, with markets characterized by large domestic demand in the region, should provide some replacement for exports to developed country markets.

6. The present report summarizes the key findings of the *Economic and Social Survey of Asia and the Pacific 2011*. It also outlines a policy agenda covering the main challenges in 2011 and over the medium term, and indicates ways of enhancing regional integration through greater connectivity. In addition, the *Survey* suggests how to increase the productive capacity of the least developed countries.

II. Coping with sluggish growth in developed countries

7. In 2010, the region witnessed a dramatic "V-shaped" recovery in growth. In fact, growth started to gain momentum from the first quarter of 2009, although many export-oriented economies only moved into positive territory around the third quarter. For the economies most affected, following the initial critical support to growth through massive fiscal stimulus packages, the key driver of private-sector recovery was renewed strength in exports. Exporting economies began their recoveries in part through intraregional sales to the large robust economies in Asia and the Pacific and eventually to the developed economies that saw improved demand beginning in late 2009.

8. After an initial strong recovery, the United States of America and the European Union are suffering from sluggish growth, which was partly responsible for the region's falling monthly export growth numbers in recent months.

9. The recent earthquakes and tsunami in Japan will also have repercussions across the region. However, the effects might be limited. The Economic and Social Commission for Asia and the Pacific (ESCAP) estimates that a 1.0 percentage point slowdown in Japan relative to 2011 baseline growth would result in a 0.1 percentage point slowdown for Asian and Pacific developing economies as a whole. The economies most affected would be Singapore (0.24 percentage points), Indonesia (0.16 percentage points) and Malaysia and Thailand (0.13 percentage points).

Managing the repercussions from the European debt crisis

10. The economies in the Asia-Pacific region should prepare for possible spillovers from the public debt crisis in European economies.[2] In recent months, the bailouts of Greece, Ireland and Portugal, as well as concerns about Spain, have led to credit downgrades that have increased the costs of debt servicing. But global financial markets have yet to be convinced, and sovereign debt defaults remain a concern.

11. The risk for Governments of countries in Asia and the Pacific lies in the possibility that any resulting financial contagion would spark off another seizure in global interbank lending. While the banking sector in most of the region is healthy

[2] For further details, see Economic and Social Commission for Asia and the Pacific, "The European debt crisis: implications for Asia and the Pacific", *MPDD Policy Brief*, No. 4 (August 2010). Available from http://www.unescap.org/pdd/publications/me_brief/mpdd-pb-4.pdf.

at the domestic level, in some economies it is exposed to global shocks due to dependence on borrowing from abroad.

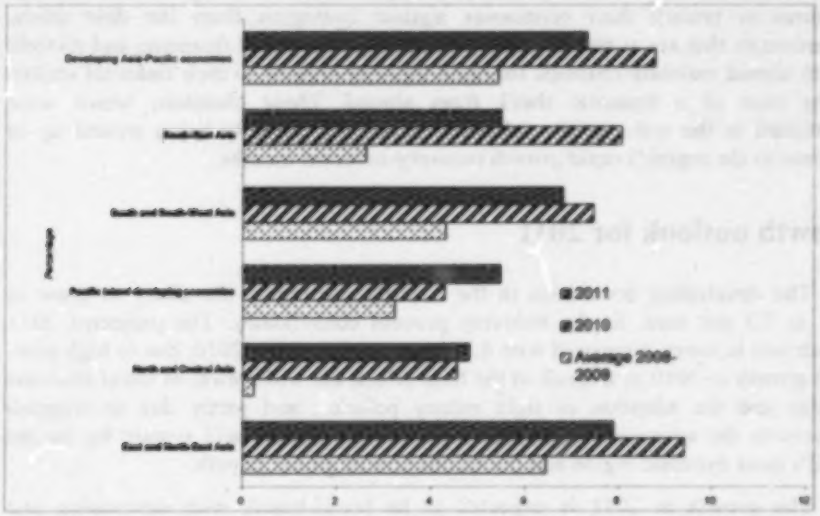
12. In such a climate of uncertainty, policymakers in the region should adopt measures to protect their economies against contagion from the debt crisis. Governments that are at risk of sharp withdrawals of external financing and a credit crunch should maintain channels for rapid liquidity support to their financial sectors in the case of a financial shock from abroad. These channels, which were established in the wake of the subprime crisis, are currently being wound up in response to the region's rapid growth recovery in recent months.

III. Growth outlook for 2011

13. The developing economies in the Asia-Pacific region are likely to grow in 2011 at 7.3 per cent, as the recovery process consolidates. The projected 2011 growth rate is lower, compared with 8.8 per cent achieved in 2010, due to high post-crisis growth in 2010 as a result of the base effect, the withdrawal of fiscal stimulus policies and the adoption of tight money policies, and partly due to sluggish recovery in the advanced economies. Asia and the Pacific will remain by far the world's most dynamic region and the locomotive of global growth.

14. The growth in 2011 is expected to be broad-based, with developing and transition economies in East and North-East Asia growing at 7.9 per cent, in North and Central Asia at 4.8 per cent, in Pacific island developing economies at 5.5 per cent, in South and South-West Asia at 6.8 per cent and in South-East Asia at 5.5 per cent (see figure I).

Figure I
Economic growth rates of developing economies in the Asia-Pacific region, 2008-2011



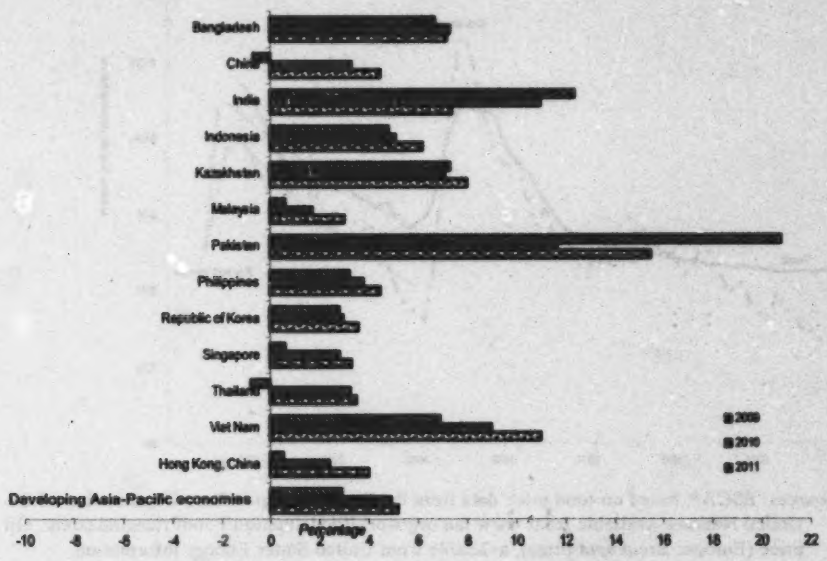
Sources: ESCAP calculations based on national sources; International Monetary Fund, *International Financial statistics database* (Washington, D.C., March 2011); Asia Development Bank, *Key Indicators for Asia and the Pacific 2010* (Manila, 2010); and ESCAP estimates.

Notes: Gross domestic product (GDP) growth for 2010 and 2011 are estimates and forecasts, respectively.

15. Large developing economies in the region should continue to grow strongly. The fastest-growing major economies in 2011 are expected to be China and India, with a forecast growth of 9.5 per cent and 8.7 per cent, respectively, followed by Indonesia at 6.5 per cent. India and Indonesia will benefit from robust consumption and investment, and China should respond to Government measures to move towards a more consumption-driven economy.

16. In 2011, most economies are likely to see an increase in inflation (figure II). To some extent, the inflationary pressures reflect a resumption in growth. However, inflation will also result from rising food and energy prices, which have a particularly damaging impact on the poor and vulnerable. Furthermore, there are significant risks resulting from capital inflows caused by excess global liquidity. In response, several economies have tightened monetary policy, adding to pressure on growth.

Figure II
Consumer price inflation[a] of selected developing economies, ESCAP region, 2009-2011



Sources: ESCAP, based on figure I above.

Notes: Rates of inflation for 2010 are estimates and those for 2011 are forecasts (as at 2 March 2011). Developing economies of the region comprise 37 economies (excluding the Central Asian countries), and the calculations are based on the weighted average of gross domestic product figures in 2009 United States dollars (at 2000 prices).

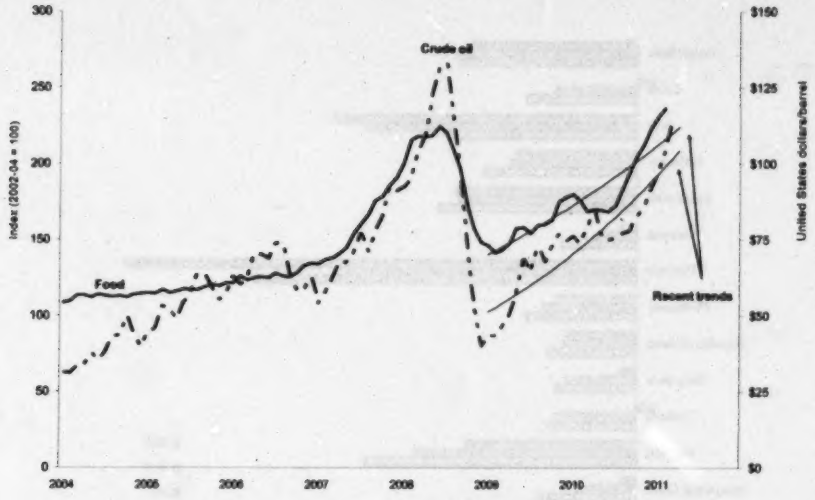
[a] Changes in the consumer price index.

IV. Key challenges to the outlook: protecting growth from external pressures

A. Return of food and fuel crises: impacts on income and poverty

17. Rising food and energy prices are emerging as an issue of serious concern across much of the region in a manner reminiscent of the 2007-2008 period just before the onset of the financial crisis. Since 2010, global food and oil prices have been on a sustained and synchronized upward trend. The food price index of the Food and Agriculture Organization of the United Nations (FAO) in December 2010 exceeded its previous record value that had been recorded in 2008 (see figure III). Since crossing that record level, the index continued to set new records in a number of subsequent months, with increasingly dire impacts on the livelihoods of the poor and contributing to social upheaval across the globe. Since 2010, oil prices have also been rising rapidly, with increased global demand due to growth recovery in emerging markets coupled with a number of supply shocks, particularly due to geo-political instability in the Middle East.

Figure III
Food price index and crude oil price, 2004-2011



Sources: ESCAP, based on food price data from the Food and Agriculture Organization of the United Nations, available from www.fao.org/worldfoodsituation/FoodPricesIndex/en/. Oil price (Europe: Brent spot price), available from United States Energy Information Administration, www.eia.doe.gov/dnav/pet/pet_pri_spt_s1_d.htm.

18. ESCAP estimates that there is a risk that high energy price increases can reduce growth by up to 1 percentage point in some developing Asia-Pacific economies as well as put pressure on inflation and adversely affect current accounts (see table 1). High oil prices will increase costs for domestic industry, while also pushing up the price of imports and reducing demand for exports. In addition, businesses will be affected by the slowdown in exports to developed economies due to constrained consumption in these economies related to higher energy costs.

Table 1
Summary of oil price impacts on macroeconomic variables for developing countries in the Asia-Pacific region

	$10 oil price increase			*$25 oil price increase*		
Countries	*Output growth*	*Inflation*	*Current account to GDP ratio*	*Output growth*	*Inflation*	*Current account to GDP ratio*
China	-0.13	0.28	-0.17	-0.36	0.77	-0.49
India	-0.23	0.52	-0.16	-0.64	1.46	-0.47
Indonesia	-0.18	0.26	-0.06	-0.49	0.73	-0.15
Malaysia	-0.16	0.33	0.23	-0.44	0.92	0.68
Philippines	-0.27	0.39	-0.14	-0.75	1.09	-0.39

Countries	$10 oil price increase			$25 oil price increase		
	Output growth	Inflation	Current account to GDP ratio	Output growth	Inflation	Current account to GDP ratio
Republic of Korea	-0.23	0.34	-0.16	-0.64	1.46	-0.47
Singapore	-0.33	0.26	-0.24	-0.91	0.74	-0.68
Thailand	-0.22	0.19	-0.37	-0.62	0.94	-1.06
Developing Asia-Pacific countries	-0.17	0.31	-0.25	-0.47	0.87	-0.73

Source: ESCAP computations in the framework of the Oxford Economic Forecasting model.
Notes: Under the baseline assumption of the Brent crude oil price being $105 per barrel; impacts are shown in absolute percentage differences from the baseline scenario.

19. Of even greater direct impact on the poor and vulnerable would be rising food prices. Since 2009, general food prices have increased in various countries by as much as 35 per cent. ESCAP estimates that an additional 19.4 million people in the region are living in poverty due to increased food prices in 2010. ESCAP has also estimated the impact on poverty of a number of possible food and energy price scenarios in 2011 (see table 2). Under the most pessimistic scenario in which there are further increases in food inflation and oil prices, with staple food prices in 2011 rising above the consumer price index inflation at twice the 2010 rate and the average oil price reaching $130 per barrel, an additional 42.4 million people could remain in poverty. This would result in a loss of up to five years in the efforts of many countries to achieve Goal 1 of the Millennium Development Goals, on eradicating extreme poverty and hunger, including the least developed countries, such as Bangladesh, the Lao People's Democratic Republic and Nepal.

Table 2
Effect of different staple food price scenarios (millions)

	Scenario 1			Scenario 2			Scenario 3		
	Staple food inflation in 2011, at half the 2010 rate and $105 oil price			Staple food inflation in 2011, at same rate as in 2010 and $115 oil price			Staple food inflation in 2011, at twice the 2010 rate and $130 oil price		
	Urban	Rural	Total	Urban	Rural	Total	Urban	Rural	Total
Pushed into poverty	0.1	1.3	1.5	1.5	3.7	5.1	3.9	13.9	17.8
Prevented from getting out of poverty	1.9	6.5	8.3	2.6	12.5	15.1	3.6	21.0	24.6
Total	**2.0**	**7.8**	**9.8**	**4.1**	**16.2**	**20.2**	**7.6**	**34.8**	**42.4**

Source: ESCAP secretariat based on data from the global information and early warning system website and the World Bank global income distribution dynamics data set.
Notes: Values may not sum to total due to rounding.

B. Addressing the challenge of rising food prices

20. Depending on the degree of impact of food price inflation on other product prices, and on related wage demands, Governments are likely to respond with monetary policy. However, they will also need to address the supply-side causes of food price increases and reduce the impact of such increases on the poor and vulnerable sections of society.

21. Measures to address the causes of food price increases should include, first, international cooperation and regulation to curb financial speculation in commodity prices. If such regulation is confined to the United States or the European Union, this could simply deflect trading to other jurisdictions. The effort therefore needs to be global through forums such as the United Nations or the Group of Twenty.

22. Second, price volatility of food grains should be addressed through the countercyclical use of buffer stocks. Third, vulnerable sections of the population should be protected through public food distribution systems, and social protection should be strengthened through food vouchers or targeted income transfer schemes,[3] besides reducing prices through lowering tariffs and taxes. Midday meals schemes, already in use in many schools, can also protect the nutritional security of children.

23. Finally, in the medium term, efforts should be made to deliver a supply response by reversing the neglect of agriculture in public policy through enhancing support for agricultural research, development and extension and by providing easier access to credit and other inputs in order to foster a new, knowledge-intensive "green revolution" that would make agriculture more environmentally resilient.[4]

24. At the regional level, price shocks can be managed cooperatively by establishing regional food stocks such as the rice reserve initiative of the Association of Southeast Asian Nations (ASEAN+3) and the South Asian Association for Regional Cooperation (SAARC) Food Bank. Agricultural productivity can also benefit from South-South and triangular cooperation on knowledge and technology transfer.

C. Managing capital inflows

25. As a result of accommodative monetary policies and low interest rates in developed economies, investors are turning their attention instead to developing economies. Other than reallocation of existing funds by financial institutions, there is once again the burgeoning "carry trade", using borrowings in foreign currencies to invest in higher-yielding currencies in both the developed and developing countries.

26. Such investments include currency deposits in local banks, portfolio investment in the bond and equity markets and corporate bond and equity issues, as well as lending to domestic banks and local subsidiaries. Equity markets in the Republic of Korea, the Philippines and Thailand, for example, are already at their pre-crisis peaks. Many investors have also turned to property, both in emerging

[3] For further details, see *Sustainable Agriculture and Food Security in Asia and the Pacific* (United Nations publication, Sales No. E.09.II.F.12).

[4] For further details, see *Economic and Social Survey of Asia and the Pacific 2010* (United Nations publication, Sales No. E.10.II.F.2).

economies such as China as well as in high-income economies such as Hong Kong, China and Singapore. As result, the Asia-Pacific region has seen some of the world's steepest increases in property prices.

27. Many economies in the region have current account surpluses that would put upward pressure on exchange rates. But capital inflows have introduced additional appreciation pressures, including for economies running current account deficits, such as India. Most major currencies in the region have risen significantly since 2009. Stronger currencies make it even more difficult to address the challenges of a current account deficit for macroeconomic stability. [5]

28. Economies have attempted to insure themselves against the risk of sudden capital outflows by building up foreign exchange reserves. But these may be inadequate. A vulnerability yardstick developed by ESCAP indicates that the reserves of a number of countries are substantially exceeded by their overall gross external liabilities.[6] Apart from not being a guaranteed insurance policy, building up reserves is also costly and a second-best solution for managing capital inflows.

29. Capital controls should be seen as important elements of the policy tool kit for reducing the volatility of the capital flows, as has been recommended by ESCAP previously.[6] Some economies in the region have imposed capital controls over the past year, an approach which is now supported even by the International Monetary Fund.[7] Developed economies should also support the imposition of such controls while also taking measures of their own, for example, by taxing capital outflows as well as by imposing high-margin requirements on foreign exchange derivatives that mimic actual outflows.[8]

D. Unemployment remains a concern for the vulnerable

30. Growth in the region has supported a recovery in many labour markets but there are still acute concerns about the quality of jobs and the vulnerability of workers. The region's more developed economies where labour markets have not returned to pre-crisis levels will also need policies that foster job-rich growth. Nevertheless, in most countries unemployment was lower in 2010 than in 2009.

31. The most serious problems are for youth, who are 3.2 times more likely than adults to be unemployed. In South-East Asia and the Pacific, that ratio rises to 4.7, the highest among the world's subregions. Across the region, some 1.1 billion workers remain in vulnerable employment. For instance, 47 per cent of workers are living with their families on less than $2 a day, and 23 per cent of workers are living in extreme deprivation on less than $1.25 a day.

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[5] See Yilmaz Akyuz, "Capital flows to developing countries in a historical perspective: will the current boom end in a bust?", South Centre Research Paper, 37 (2011). Available from www.southcentre.org/index.php?option=com_docman&task=doc_download&gid=1974&Itemid=182&lang=es.

[6] For more details, see *Economic and Social Survey of Asia and the Pacific 2010*, pp. 21 and 22.

[7] International Monetary Fund, "IMF develops framework to manage capital inflows", *IMF Survey*, 5 April 2011. Available from http://ftalphaville.ft.com/blog/2011/03/28/529131/more-on-uncertainty-and-capital-controls/.

[8] See, for example, Stephany Griffith-Jones and Kevin P. Gallagher, "Curbing hot capital flows to protect the real economy", *Economic and Political Weekly* (January 2011), pp. 12-14. Available from http://ase.tufts.edu/gdae/Pubs/rp/Griffith-Jones_GallagherEPWJan11.pdf.

32. As labour markets in the Asia-Pacific region recover and policymakers seek to rebalance their economies, they will need to focus more on quality jobs and incomes. A post-crisis macroeconomic framework should aim at full employment, for men and women, as a core policy goal, in addition to addressing economic growth targets, inflation and sustainable public finances. As countries in the region reconsider their fiscal policies, and their sustainability, it is critical to incorporate a basic social floor. In addition to reducing insecurity for the poor, improved social protection can support countries in their efforts to rebalance the sources of growth. The crisis has prompted some countries in the region, including Malaysia and the Philippines, to consider establishing unemployment insurance schemes, while India has expanded its national rural employment guarantee scheme.

E. Support alternative sources of demand

33. In the medium term, the fundamental challenge for the economies in the Asia-Pacific region will be to substitute in some measure the demand from developed economies with local demand.[9] This will not only sustain growth but will also help to reduce global imbalances. At the national level, reducing the dependence on consumption from the developed world will mean both increasing domestic demand in the major economies and boosting intraregional trade. In East Asia and, most importantly, in China, the main shortfall is in consumption, while in South-East Asia, it is in investment.

34. Boosting domestic consumption should mean increasing the consumption rates of the poor and also offering social protection programmes that will enable them to reduce precautionary savings for health and education needs. In the case of investment, funds should be directed to narrowing development gaps, most notably in infrastructure. As well as using domestic resources for investment, countries should also be able to benefit from the region's considerable foreign exchange reserves, through the establishment of a regional infrastructure financing mechanism. A recent study has estimated the infrastructure needs of the Asia-Pacific region for 2011-2020 at around $8 trillion ($5.4 trillion for new capacity and $2.6 trillion for replacement of old infrastructure), or $800 billion per year.[10] In that context, a regional financial architecture could serve as an intermediary between the region's $5 trillion of foreign exchange reserves and its unmet infrastructure needs. One option would be an infrastructure development fund managed by a regional institution. If this utilized just 5 per cent of the region's reserves, it would have a start-up capital of $250 billion, besides the ability to borrow from central banks. The region would also need to catalyse private investments, for example, through public-private partnerships. Economies in the Asia-Pacific region also have the opportunity to develop new greener industries, saving energy and materials and providing more affordable products to the poor while maintaining growth and enhancing the environmental sustainability.

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[9] For a full discussion of the issues summarized in this section, see *Economic and Social Survey of Asia and the Pacific 2010* (United Nations publication, Sales No. E.10.II.F.2), chap. 3.

[10] Asian Development Bank and Asian Development Bank Institute, *Infrastructure for a Seamless Asia* (Tokyo, Asian Development Bank Institute, 2009). Available from http://www.adbi.org/book/2009/09/15/3322.infrastructure.seamless.asia/.

F. Development-friendly global economic governance

35. The Group of Twenty has adopted a framework for strong, sustainable and balanced growth.[11] The Asia-Pacific region could significantly contribute to this by boosting aggregate global demand, while also addressing the region's most urgent development needs. The Asia-Pacific region has eight members of the Group of Twenty who could coordinate their positions to ensure that a new international financial architecture meets the region's development needs. The Group of Twenty can further enhance its credibility and effectiveness by evolving mechanisms for consultation with the non-member countries, as was arranged by ESCAP prior to the summit held in Seoul. Important proposals include establishing a special-drawing-rights-based global reserve currency that could be issued countercyclically; a global tax on financial transactions to raise resources for achieving the Millennium Development Goals, besides moderating short-term capital flows; and international regulations to curb excessive risk-taking by the financial sector. The Group of Twenty should also take measures to moderate the volatility of food and oil prices that are highly disruptive in the process of development. In the case of food price volatility, the Group of Twenty may act to regulate the speculative activity in food commodities and discipline the conversion of cereals into biofuels. It may expedite the implementation of the L'Aquila Food Security Initiative, which included provision of financing to developing countries for food security. In the area of oil price volatility the Group of Twenty, representing the major oil consumers, could demarcate a benchmark "fair" price for oil with oil-producing countries and obtain agreement to restrict oil price movement within a band around it. An additional measure to moderate the volatility in the oil markets is for the Group of Twenty to create a global strategic reserve and release it countercyclically. In these and other areas, the Asia-Pacific region can further integrate and coordinate its actions.

V. Connectivity to boost regional integration

36. Regional demand can be boosted through greater economic integration, driven by populous and rapidly growing economies such as China and India whose dynamic domestic markets can also benefit their smaller and poorer neighbours. But this cannot be taken for granted. The rising tide of development opportunities will not lift all boats if these are separated by water locks. These obstructions can take the form, for example, of restrictive non-tariff measures, complicated and time-consuming customs procedures, differences in regulations and poor transport infrastructure. As a result, the enormous opportunities generated by the more dynamic centres may stop at their national borders.

Intraregional trade

37. Intraregional trade among countries in the Asia-Pacific region has expanded at a faster pace than their global trade, bringing its share to nearly 52 per cent in 2008. The analysis contained in the *Survey* shows that the potential of intraregional trade remains to be fully exploited partly due to high trade costs, which include not only

[11] See leaders' statement, the Pittsburgh Summit, 24 and 25 September 2009. Available from www.pittsburghsummit.gov/mediacenter/129639.htm.

import tariffs but also onerous customs procedures and restrictions on the movement of vehicles and trains across borders.

38. The potential for greater trade is evident from the extent of complementarities between and within Asia-Pacific subregions, in particular between East and North-East Asia and South-East Asia and within East and North-East Asia. Interestingly, for four of the five subregions trade complementarities were greater with other subregions than within the subregions themselves. Regional integration should focus therefore not just on deepening integration within subregions but also on fostering trade links across subregions.

Intraregional foreign direct investment

39. In the past, most foreign direct investment inflows to countries in the Asia-Pacific region came from developed countries, but nowadays an increasingly larger proportion comes from developing countries. In recent years China, India, Malaysia, the Russian Federation and Singapore have become important sources of foreign direct investment. Transnational corporations from these and other developing countries in the region tend to invest in neighbouring countries that have similar economic conditions and institutions — contributing much-needed investment and technological expertise that can enhance the productive capabilities of lower-income countries. As a result, many low-income countries in Asia and the Pacific now get most of their foreign direct investment from other developing countries in the region.

Preferential trading arrangements

40. The countries in the Asia-Pacific region have been very active in pursuing preferential trading arrangements in recent years and as at the end of 2010 were party to 170 of them. Because of their bilateral and subregional nature, these agreements are not contributing to create a seamless, broader and unified Asian and Pacific market. Two important initiatives in that direction are the East Asia Free Trade Agreement and the Comprehensive Economic Partnership of East Asia.

41. In particular, the Comprehensive Economic Partnership of East Asia, covering about 80 per cent of the region's population and gross domestic product, could constitute the nucleus for an incipient wide free trade area in Asia and the Pacific, to which other countries in the region could accede. A complementary option would be a regional framework to link various subregional groupings in a preferential arrangement. As a broader regional forum with convening power, ESCAP could facilitate emergence of such broader arrangements in the region. Considering the diverse levels of development in the region, the regional trading arrangements should not only include special and differential treatment provisions but also incorporate economic cooperation to narrow the development gaps.

Transport links

42. Export growth has resulted in a rapid expansion of maritime shipping. As of 2009, Asia had the world's top five container ports — Singapore, Shanghai, Hong Kong, China, Shenzhen and Busan — which accounted for 23 per cent of the world's total container ports. As a result, much economic development has been concentrated around major maritime ports, where many Governments have opened special economic zones or export processing zones. Meanwhile, large hinterland

areas have remained relatively underdeveloped. Moving goods to the hinterlands of some countries and across countries is still expensive, as a result of long distances, high operating costs for trucks due to poor roads and aging vehicles, high trans-shipment costs and complex border crossing procedures. In addition, the Pacific island developing economies face high costs because of low volumes.

43. The Intergovernmental Agreement on the Asian Highway Network[12] and the Intergovernmental Agreement on the Trans-Asian Railway Network,[13] which were signed under ESCAP auspices, have contributed to infrastructure investment and also triggered several multilateral initiatives. For instance, the Asian Development Bank, in collaboration with ESCAP, has recently initiated a project on the development of priority Trans-Asian Railway routes and Trans-Asian Railway lines. The main current challenge for transport connectivity is to improve linkages between modes, for example, between ports and roads and railways. It will also be important to extend routes to hinterland areas and through landlocked countries and transit countries as well as to small island developing States in the Pacific. To assist in the integration of networks, ESCAP is developing a third intergovernmental agreement focusing on international dry ports across the Trans-Asian Railway and Trans-Asian Railway networks.

Trade and transport facilitation

44. Many countries now realize the importance of streamlining trade procedures. For that purpose, they are relying more on electronic data interchange and aim to institute national electronic single windows through which traders can submit required documentation, pay duties and receive clearance. Although economies such as Singapore, the Republic of Korea and Hong Kong, China, are world leaders in that area, the full benefits of single windows cannot be realized until the electronic data and documents in a national single window can be accepted by authorities in partner countries. Often the problem is the lack of cooperation and coordination across national agencies within countries. While those issues are national, they also affect connectivity with neighbours and the rest of the region. One option for improving inter-agency cooperation and coordination is for Governments to designate single national lead agencies.

45. The overall efficiency of international transport will also depend on the harmonization of legal regimes. The Almaty Programme of Action[14] indicates that landlocked developing countries should consider international conventions, and regional and bilateral agreements, as the main vehicles for harmonization, simplification and standardization. However, progress under ESCAP resolution 48/11 of 23 April 1992, which recommended that countries in the ESCAP region accede to seven international conventions, has been uneven. The region's 12 landlocked countries have acceded, on average, to only four of the seven conventions, and only two countries, Kyrgyzstan and Uzbekistan, have acceded to all of them. Furthermore, some neighbouring transit countries of the region's

[12] United Nations, *Treaty Series*, vol. 2323, No. 41607.

[13] United Nations, *Treaty Series*, No. 46171.

[14] *Report of the International Ministerial Conference of Landlocked and Transit Developing Countries and Donor Countries and International Financial and Development Institutions on Transit Transport Cooperation, Almaty, Kazakhstan, 28 and 29 August 2003* (A/CONF.202/3), annex II.

landlocked countries have acceded to even fewer conventions, leading to a territorial discontinuity in their application which significantly reduces their effectiveness.

Information and communications technology connectivity

46. The most striking development in information and communications technology (ICT) connectivity has been the rapid diffusion of mobile networks and services. As a result, many poor people now have access to telecommunication services. In contrast, the region's developing countries have very low broadband penetration, well below 10 per cent. An important obstacle to better Internet services is the cost of deploying land-based or submarine fibre-optic cables. However, there has been some progress in the Pacific, where some least developed countries have benefited from linkages to existing cables.

47. In order to boost ICT connectivity, Governments will need policies at both national and regional levels. At the national level, it is important to set up regulatory frameworks that (a) promote the development of fair and competitive markets; (b) establish national standards which are compatible with international standards; and (c) encourage the development of innovative applications, such as mobile banking. For this purpose, it is advisable to establish independent regulators that can act in the best interests of both the State and end-users. At the regional level, it is important to take into account potential synergies between ICT infrastructure and other kinds of physical infrastructure.

Energy connectivity

48. Energy is a critical production input. As a result, disruptions in availability, or price increases, can have serious economic consequences. A fundamental goal is therefore energy security, understood as both a stable supply for importing countries and a stable demand for exporting countries. The Asia-Pacific region has both large energy-importing and large energy-exporting countries; energy security would therefore benefit from better physical connectivity between them as well as institutions to promote cooperation.

49. For connectivity, it may be useful to identify missing infrastructure links — considering investment needs from a region-wide perspective and taking into account projected increases in energy demand. In that respect, the Trans-Asian Railway and Trans-Asian Railway agreements could provide useful models. Other important issues to consider in the area of energy cooperation are pipeline security and safety and low-carbon paths that place more emphasis on efficiency and take greater advantage of renewable resources. Finally, it is important for the region to develop a deep, liquid and transparent market for crude oil, oil products and gas. Building blocks of such a market include identifying a crude oil price benchmark relevant for the region; gathering support from key buyers and sellers to ensure adequate trading volumes; building adequate storage infrastructure and creating a conducive regulatory framework; and ensuring robust financial markets to support hedging and trading. In order to foster energy cooperation on a sustained basis in the region, it could be useful to establish a structured Asia-Pacific regional energy dialogue.

People-to-people connectivity

50. People-to-people connectivity could help promote better mutual understanding, enhanced trust and greater respect for diversity, thus contributing to a culture of peace. The Asia-Pacific region is a growing source and destination of migrants for higher education and overseas employment as well as for tourism. While the majority of Asia-Pacific migrant workers leave the region, a significant proportion move within the region. For creating a legal framework for migration, subregions such as North and Central Asia, South-East Asia and the Pacific have already moved ahead with multilateral agreements, while some countries have established bilateral memorandums of understanding that establish guidelines and procedures for employment protection and the return of workers.

Financial cooperation

51. The region already has a number of initiatives for financial cooperation. These include the Chiang Mai Initiative Multilateralization, the Asian Bond Fund and the Asian Bond Market Initiative. Most, however, are in their early stages and have limited scope and coverage. The region needs a more developed regional financial architecture that could not only help to manage financial crises but could also provide an adequate supply of development finance.

52. To strengthen crisis management, the region could build on its pioneering initiative for financial cooperation, the Chiang Mai Initiative Multilateralization. This would involve expanding its membership to cover important countries like Australia, India and the Russian Federation and also increase its pool of resources. A well-endowed, and truly regional, crisis response facility of this type could reduce pressure on Governments to build large foreign exchange reserves. At the same time, the region needs a way to use its large savings to meet its equally large needs for infrastructural investment. For that purpose, it will need to deepen its financial markets and integrate its capital markets. In addition, it could consider creating a regional infrastructure development fund to deploy a small part of the region's foreign exchange reserves for infrastructure financing.

53. Additional elements of a regional financial architecture include: (a) improving exchange rate coordination to facilitate trade and macroeconomic stability and discourage competitive devaluations; (b) achieving closer cooperation between central banks and financing institutions to facilitate region-wide information-sharing and capacity-building among the region's least developed countries; (c) expanding public-private partnerships for investment in infrastructure by building capacities among policymakers, especially in the design of legal and regulatory regimes and in project development and management; and (d) active participation in global discussions on the reform of the international financial architecture to ensure that it supports the region's developmental needs.

IV. Building the productive capacity of the least developed countries

54. If the least developed countries are to benefit from greater connectivity and regional integration, they will need to increase their productive capacity. In the past 40 years, however, the region's least developed countries have made little progress

on that front. Their share of global GDP is less than a tenth of their share of global population, their share of exports has been lower than 0.25 per cent, and their contribution to manufactured exports has been lower than 0.2 per cent (see table 3).

Table 3
Share of least developed Asia-Pacific countries in international production and trade (percentage)

Indicator	*1970*	*1980*	*1990*	*2000*	*2007*	*2008*	*2009*
Population	3.18	3.21	3.44	3.65	3.83	3.78	3.86
GDP	0.43	0.22	0.18	0.22	0.23	0.24	0.25
Manufacturing, value added	0.60	0.14	0.16	0.16	0.20	0.31	0.58
Merchandize exports	0.11	0.12	0.09	0.17	0.19	0.19	0.24
Manufactured exports	0.01	0.06	0.07	0.16	0.12	0.04	0.01
High-technology exports	..	..	0.00	0.00	0.01	0.00	..

Source: ESCAP secretariat, based on data from the World Bank.

55. A renewed focus on building the productive capacity of the least developed countries should bring production back to the core of the development agenda. This should not mean, however, simply producing more of the same goods and services; least developed countries also need to expand the range of goods produced. Historically, it has been evident that as economies grow, they produce and export a much wider range of products. Increasing output in the least developed countries will require similar diversification.

56. As economies diversify, they also tend to export products that are exported by fewer other countries. This will generally mean more exclusive manufactured goods as opposed to more common exports such as vegetable oils, fish, textiles, garments or mining products. The countries in the region with more diversified production and more exclusive product mixes are Australia, China, India and Japan. The least developed countries, on the contrary, have not diversified and continue to produce fairly standard goods. This is also the situation in all the Pacific island developing economies. To some extent, this is a result of their small market size, owing to which they face an inherent disadvantage in their process of diversification.

57. Countries wishing to diversify can anticipate competition since most other countries are aiming to move in a similar direction. Between 1984 and 2009, the average diversification of countries participating in international trade rose from 968 to 1,868 products. In addition, for the average country the number of countries exporting a similar product mix increased from 41 to 91.

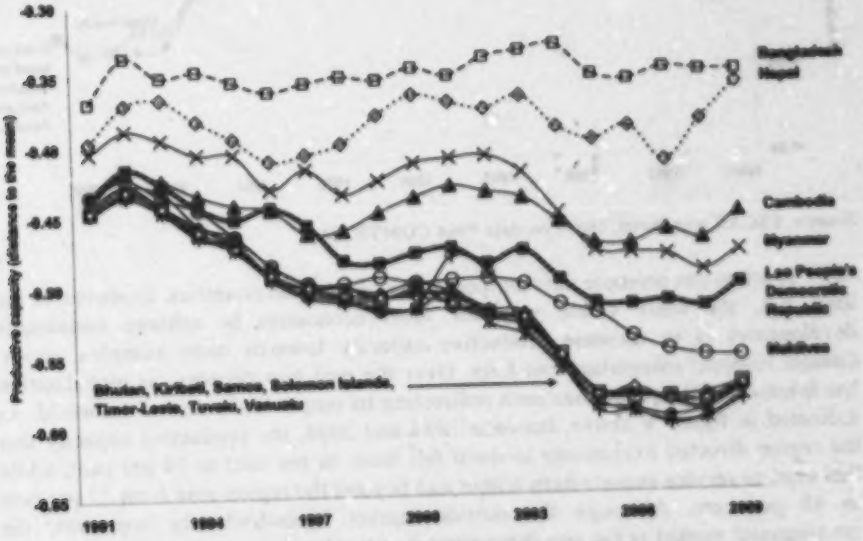
58. The process of diversification is path dependent: products that a country produces today affect those it will be able to produce tomorrow. As a result, diversifying towards some products would increase the range of possibilities for further diversification. Poorer countries need to choose the most appropriate new products for strategic diversification and the easiest will be those for which the required capabilities are similar to those already available.

59. In assessing the current level of productive capacity, it can be assumed that the fewest capabilities will be found in the countries that are the least diversified and

whose product mixes are similar to those of many other countries. This information on diversification can be combined with other measures to arrive at a composite "productive capacity index".

60. The results for least developed countries in Asia and the Pacific are indicated in figure IV, in which the level of productive capacity in each country is compared with the global mean over time. Bangladesh and Nepal have held their positions, while all the other countries, despite recent rises, have generally lost ground, not because they have reduced productive capacity but because they have progressed more slowly than others. This highlights the special circumstances that these countries face and the need for better targeted assistance and strategies for improving productive capacity.

Figure IV
Evolution of average productive capacity of least developed countries in the Asia-Pacific region, 1991-2009,

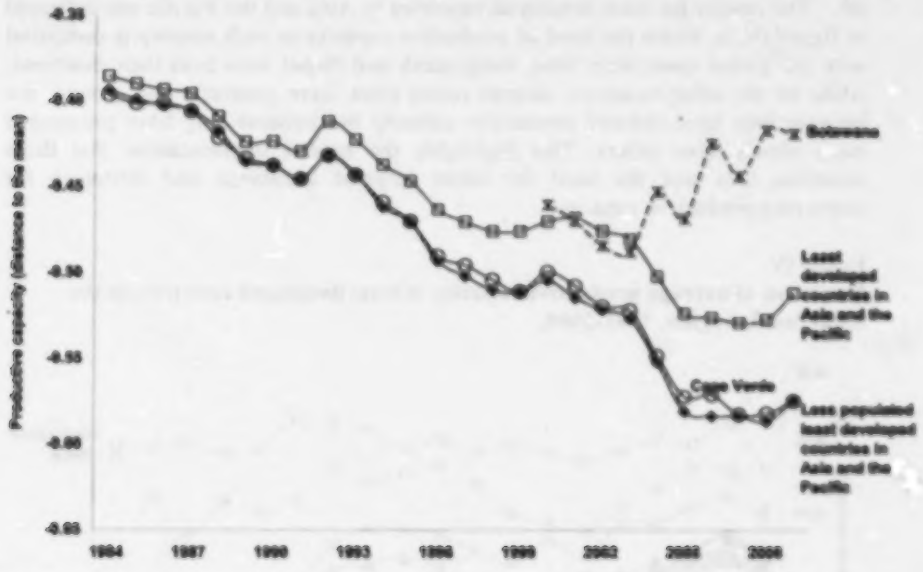


Source: ESCAP secretariat, based on data from COMTRADE.

61. It should be emphasized that small least developed countries can boost their per capita GDP, and thus their prospects for graduation from least developed country status, by exploiting and expanding tourism and other services.

62. Analysis suggests that, after controlling population size and the level of productive capacity, a 1.0 per cent increase in tourism revenue increases the total output of a country by around 0.25 per cent. The two least developed countries in Asia and the Pacific already recommended for graduation could follow a similar path. For Maldives, which graduated in January 2011, tourism makes up 50 per cent of GDP. For Samoa, which is set to graduate in 2014, tourism makes up 21 per cent of GDP.

Figure V
Evolution of productive capacity of least developed countries in the Asia-Pacific region and other graduating countries, 1984-2009



Source: ESCAP secretariat, based on data from COMTRADE.

63. Tourism can promote development in less populated countries. However, in the long run, the most viable way for most economies to achieve sustainable development is to increase productive capacity towards more complex goods. Greater regional integration can help. Over the past two decades, as globalization has intensified, the region has been redirecting its output to the rest of the world. As indicated in figure V above, between 1984 and 2008, the productive capacity that the region directed exclusively to itself fell from 40 per cent to 14 per cent, while that used to service exports both within and beyond the region rose from 22 per cent to 48 per cent. Although the outside market is undoubtedly important, the intraregional market is the one that generally provides the opportunities for moving to more complex products, serving as a training ground for exporting to the rest of the world. Hence, facilitating intraregional trade can also increase productive capacities.

64. Increasing productive capacities is not only a matter involving the more efficient exploitation of existing comparative advantage. It requires exploration of new economic activities and a more strategic approach towards building up capabilities to produce goods that are more exclusive and that are only produced by countries that are more diversified.

65. A pragmatic strategy for least developed countries to build their productive capacities is to let those capacities be generated or acquired as part of the process of such strategic diversification through the combined efforts of the State and the private sector, with a supportive role played by development partners. Such a strategy comprises three main processes, which, when set in motion, can act as an

algorithm for discovering, acquiring and spreading the productive capacities required for developing economies to catch up to more developed economies.

66. The first process is differentiation through strategic product innovation including the identification and production of products that are new to the firms or farms in the economy and that are more complex and facilitate further diversification. The second process is the selection of the business models of those firms and farms that were successful in the differentiation process. The third process is the amplification of the successful business models and the exploitation of the new market. It is important to the strategy that these processes be repeated continuously.

67. The experience of developed and newly industrialized countries has demonstrated the critical role played by strong and active intervention by the "development State" in the early stages. In what follows, a policy agenda for national action is outlined, as is a global partnership for implementing the strategy to increase the productive capacities of least developed countries, drawing upon the outcome of the High-level Asia-Pacific Policy Dialogue on the Brussels Programme of Action for the Least Developed Countries, organized by ESCAP in collaboration with the Government of Bangladesh in Dhaka in January 2010 (E/ESCAP/66/6).

National policy framework

Stable investment-friendly macroeconomic policy framework

68. Least developed countries need to maintain strong macroeconomic fundamentals. Countries need to utilize the full scope of appropriate countercyclical policies to maintain economic and financial stability in the face of shocks in order to avoid abrupt economic fluctuations.

Industrial policy and infrastructure development

69. Active public intervention is required to create infrastructure and promotional measures that are covered under industrial policy, including infant industry protection provided to a domestic industry in the early stages of development. Public investment could play a proactive role in infrastructure development and act as a catalyst of public-private partnerships by creating a virtuous cycle of investment and spurring inclusive growth.

Domestic resource mobilization

70. Least developed countries also need to foster a diversified, well-regulated and inclusive financial system that promotes savings and channels them to productive investments. The domestic supply of long-term capital also needs to be increased by developing domestic capital markets, venture capital funds and term-lending institutions, and industrial development banks in order to provide the finance required for the creation of new productive capacities.

Technological upgrading

71. The scientific, technological and research and development capacities of the least developed countries need to be built up through national programmes and supported by international institutions and programmes. Developed countries should, therefore, facilitate technology transfer to least developed countries as

required under article 66.2 of the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS Agreement). It is also timely to consider setting up a technology bank for least developed countries, which could promote the transfer of key technologies, including pro-poor, green, agricultural and renewable energy-related technologies.

Supportive global partnerships for building productive capacities in least developed countries

Financing for development: foreign direct investment and official development assistance

72. The policies aimed at harnessing the potential of foreign direct investment should stimulate productive investment, build technological capacities, develop infrastructure and strengthen linkages within and across sectors and between different enterprises. Least developed countries could also adopt associated policies, such as performance requirements, to facilitate technology transfer and diffusion from foreign direct investment. Intraregional foreign direct investment originating in other developing countries, as observed earlier, enhances the options for them. Development partners could assist in investment promotion through leveraging official development assistance and by providing risk cover and capacity-building for project development, among other policies.

73. Efforts need to be made to continue to improve the quality of official development assistance and increase its development impact. There is a need to set up special purpose thematic funds dedicated to least developed countries, such as a commodity stabilization fund, a technology fund, a diversification fund and environment-related funds. Aid for "new" purposes needs to be truly additional and should not divert resources from other internationally agreed goals.

Market access and aid for trade

74. Least developed countries need to be provided with enhanced and predictable market access, support for the establishment of export supply capacity that is competitive both in cost and quality and new trade-related infrastructure. More transparent and simplified rules of origin and more comprehensive product coverage could improve the use and value of the Generalized System of Preferences. In addition, developed countries and developing countries in a position to do so should implement fully the duty-free, quota-free market access as agreed in the Hong Kong Ministerial Declaration.[15]

75. The focus of aid for trade should be to assist the least developed countries in building productive infrastructure and trade capacities in order to enable them to participate effectively in the multilateral trading system. Aid for trade should be aligned to national development strategies. In addition, least developed countries should receive priority attention for the disbursement of funds.

South-South, triangular and regional cooperation

76. With the rise of emerging countries in the region as the growth poles of the world economy, South-South, triangular and regional cooperation have become viable strategies for development. An increasing number of countries, including

[15] World Trade Organization, document WT/MIN(05)/DEC. Available from http://docsonline.wto.org.

China, India, Malaysia, the Russian Federation, Singapore and Thailand, have well-developed programmes for assisting other developing countries, especially the least developed countries, in their neighbourhoods. Such initiatives should be further promoted and extended.

77. The Asia-Pacific region emerged from the global financial crisis as a growth driver and anchor of stability of the global economy. It now has the historic opportunity to rebalance its economic structure in its favour in order to sustain dynamism with strengthened connectivity and balanced regional development and make the twenty-first century a truly Asia-Pacific century.